DR. KURT RICHEBÄCHER

Frankfurt
GERMANY

CURRENCIES AND CREDIT MARKETS

No. 236 / December 1992

"An initiating impulse, when it comes into play, operates upon a certain complex of monetary and industrial conditions. They will determine the nature of the effect that the impulse produces, and are, in this sense, causes of industrial fluctuations. The impulse is the dropping of the match: the consequences are determined by the nature of the material with which it comes into contact."

Industrial Fluctuation, A.C. Pigou, p.8
Macmillan, London, 1927

HIGHLIGHTS

The fact remains: the industrial world is mired in a recession that continues to deteriorate. Yet, markets are again staking their bet on a U.S.-led recovery. Such hopes couldn't be more illusory.

Significantly, for the first time in more than a half century, a self-reinforcing business cycle has failed to engage in the U.S., even defying the stimulus of rock-bottom short-term interest rates.

Search as we might, we can find no sector of the U.S. economy that is capable of propelling the U.S. economy to the ignition point of a self-reinforcing, momentum-gaining recovery. We review the potential of these sectors one by one.

In our quest for a locomotive for the U.S. economy, we searched the annals of business cycle history for any illumination, particularly in the case of prolonged recessions and depressions. We review three other periods in American history where similar conditions prevailed as today.

A similarity of all three of these depressions was a sharp, protracted decline in building construction. The parallels to today are alarming.

There is no economic force in the U.S. that can offset the considerable drag from extremely weak money and credit growth, a deteriorating trade balance, the real estate deflation, and overall fiscal policy. The rest of the world, in its hopes for a U.S. recovery, stands to be deeply disappointed.

The Fed will have to continue to focus on the sustainability of a feeble expansion. That means that U.S. dollar strength can only be temporary. Short-term interest rates must stay low.

Going for growth with a fiscal boost is now the unanimous battle strategy around the globe. Britain, the U.S., and others are all drawn back to the steroid of deficit spending. Their long-term interest rates should therefore remain high.

The economic comparisons that are made of Germany and the U.S. are lopsided. Germany is facing little more than a normal, inflation-triggered, cyclical recession. To prove it, we compare the underpinnings of the major Continental European economies and the Anglo countries.

Currency and investment markets remain highly volatile and dangerous. We continue to counsel a calm, long-sighted outlook, emphasizing the high-quality government bonds of Germany, Switzerland, the Netherlands, Austria and Belgium.

IN SEARCH OF A LOCOMOTIVE

It is a fact: the industrial world remains mired in a recession that continues to deteriorate. An economic slide is deepening in Japan and Europe. Everywhere, countries are looking to ride someone else's train. Suddenly, hopes are again riding high that salvage will come from a rebounding U.S. economy. Not coincidentally, there is a widespread conviction that the U.S. economy isn't really as weak as originally thought, particularly so in comparison to other countries. A new president-elect in the U.S., Mr. Bill Clinton, has catalyzed a fresh wave of hopeful thinking. Financial markets have quickly heaped their bets on the "change" promised by a new administration whose "growth package," it is envisaged, will prove to be the long-missing elixir that will finally revitalize the U.S. economy.

Oddly, though, while talk about the U.S. economy is becoming increasingly optimistic, actual government and private economic growth forecasts have been revised downward not only for Europe and Japan but also for the United States. The latest OECD (Organization for Economic Cooperation and Development) forecast puts the combined 1993 growth of all industrial countries at only 2.1%, a significant drop from the 3% rate projected earlier in June. For the U.S. economy, growth is now projected at only 2.4% for 1993, down from the June forecast rate of 3.6%.

Why this downward revision? For the Japanese and the British economies, it's clearly a hard landing. And in the U.S. case, there is an even more belated recognition that all the interest rate cuts by the Fed have failed to ignite a normal, self-reinforcing business revival.

"Self-reinforcing" is the all-important watchword. Most economists, apparently, have lost sight of the distinction between protracted sub-par growth — as has unfolded in the United States and some other countries — and a normal cyclical recovery. The decisive feature of a cyclical recovery is that once it has started, it quickly becomes a self-reinforcing, cumulative process that builds its own momentum.

WHAT CONSTITUTES A REAL RECOVERY?

For the first time in more than a half century, a normal, self-reinforcing business cycle mechanism has failed to kick in, even defying the stimulus of rock-bottom short-term interest rates and massive deficit spending. And what's more, the current consensus forecasts of U.S. growth of only 2 - 2.5% in 1993 and 1994 imply that no cyclical acceleration is expected either.

Yet, in our view, these forecasts of positive, though sluggish, growth are flagrantly at odds with the companion forecasts of high interest rates and a rebounding dollar. Growth of 2 - 2.5% is really no recovery at all. While economists may exult over the positive sign in front of the growth rate, it's important to see that a growth rate this low does nothing more than lock in the prevailing recessionary conditions. Low growth of 2 - 2.5% barely approximates the U.S. economy's current capacity and productivity expansion. As such, unemployment, competitive and profit pressures will remain unabated. Overall, it ensures that corporations, in their attempts to generate profits, will continue to aggressively restructure their operations thus keeping employment weak. Indeed, a recent survey by the American Management Association revealed that one out of four companies surveyed plans work force reductions by mid-1993. That is the highest level reported since the survey began six years ago.

Above all, such conditions wouldn't be compatible with a substantive monetary tightening. For that to occur and lend support to the U.S. dollar would require more than just a bit of positive growth. What's needed is a true-to-type, self-reinforcing recovery.

INDEFATIGABLE MARKET OPTIMISM

What is it that has so suddenly turned the deep pessimism over U.S. economic prospects into rampant optimism? It appears important to distinguish between the market players and the general populace. The latter group — the people on Main Street, USA — are becoming increasingly worried about government debt, job security and their living standard. Indefatigable market optimism seems to lead a life of its own.

To be sure, the news of an estimated growth rate of 3.9% in U.S. GNP during the third quarter was cannon fodder for the optimists. But reviewing the details of the recent report, we remain highly sceptical. In fact, the statistics are a travesty. The growth estimate is sharply at odds with employment, production and income data. Employment in the goods-producing sector fell by 152,000, of which manufacturing accounted for a loss of 112,000 jobs. And despite surging government transfer payments, real disposable income growth was zero, the weakest since early 1991.

Consumer spending, it was estimated, jumped at an annual rate of 3.7% during the third quarter, apparently accounting for two-thirds of GNP growth. How can that be reconciled with zero real income growth? Part of the explanation is that the savings ratio declined from 5.3% to 4.5%. But most of the discrepancy is attributable to the fact that the GNP numbers are annualized. America is the only country in the world where GNP statistics are presented in this way. If it weren't for this aggrandizing annualization, nobody would be enticed to take any notice of these numbers.

Nevertheless, optimism runs deep. On Election Day and the day after, there was a large conference in Washington organized by the American Stock Exchange. It was attended by hundreds of international investors and economists. The mood was upbeat. The spin doctors were out working on a new story: that Mr. Clinton had inherited an economy from poor Mr. Bush that was in much better shape than the campaign rhetoric and media had suggested. And so the thinking went that it would be a cinch for Mr. Clinton to deliver an improving economy.

There was one discordant note at that conference in Washington: it was struck by Martin Feldstein, president of the National Bureau of Economic Research (NBER). He said something that we fully agree with: "*The U.S. economy is continuing to slow and is at serious risk of a new downturn. At minimum, it will underperform consensus expectations over the next six to nine months.*" Far from worrying about when to pull the brakes, we think the Fed will have to continue to focus on the sustainability of a feeble expansion, which has so far pitifully failed to develop any momentum of its own.

IN SEARCH OF THE IGNITION POINT

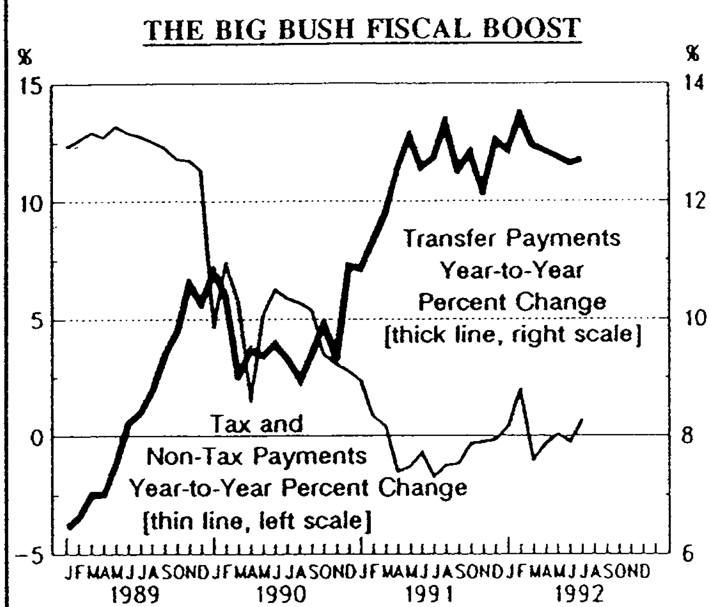
As we said before, "self-reinforcing" is the all-important watchword. Just what are the prospects for such a recovery powered by the normal business cycle dynamics. Our own assessment of the U.S. economic outlook starts with the retroactive question: What was it that propped up the U.S. economy over the past few years in the first place, feeble as growth was over that period?

Let's first look at some relevant facts: Between the end of 1989 and mid-1992, U.S. real Gross Domestic Product (GDP) rose by altogether only $34 billion (in 1987 dollars) or a minute 0.7%. During this time, exports grew by $72 billion and private consumption grew by $44 billion while residential and non-residential fixed investment actually shrank.

Plainly, what kept the U.S. economy above water since 1989 was a burst of foreign demand for U.S. goods. If that wouldn't have been the case, the U.S. economy would have experienced a much deeper recession, particularly so the manufacturing sector. The important thing to see now, is that this stimulative demand pull from abroad is over and done with as recession is spreading around the world. On the other hand, since U.S. imports are now holding up relatively better than exports, the trade balance is actually turning into a drag on economic growth. Clearly, this is one engine of economic growth that cannot be counted on for some time to come.

Then what of consumer spending? It obviously held up much better than could reasonably be expected given the protracted, miserable employment picture. This experience raises two additional questions: Why did consumer spending hold up so well, and can it last?

Actually, we already touched on these questions in the last letter when we drew attention to the massive fiscal stimulus that had taken place under the Bush administration during the last 15 months. An instructive chart that succinctly illustrates this fact comes from our old friend, Albert Sindlinger, who is one of the very few people to have spotted the huge scale of this recent fiscal stimulation. The chart is shown to the right.



Source: Sindlinger & Co.

A GLOBAL RETURN TO DEFICIT SPENDING

All of a sudden, we read glowing reports about the marvels of what new deficit spending will do for the American economy. The same is now being vaunted as a panacea for the ails of Britain and increasingly in other countries, too. Japan, Canada, and even the European Community are pondering stimulative packages under various guises. "Going for growth" with a fiscal boost is now the general battle strategy around the globe. Few people, apparently, are aware of the fact that deficit spending has already been running rampant in many countries with no more than an ephemeral impact on growth.

Since 1989, the U.S. Federal budget deficit has risen from 2.5% of GDP to 5.5% and continues to head higher. Britain's public sector deficit is bulging to an expected 7% of GDP next year — if not more — coming from a small surplus of 1.5% of GDP in 1989-90. These are dramatic swings, especially so in the case of Britain.

One has to wonder: If all this red ink has had no visible economic impact, then what will the next round of stimulus accomplish? The general answer we hear is that the past years' deficits lacked the normal stimulative impact because they were an involuntary outgrowth of economic weakness rather than being actively planned boosts such as are being planned by Clinton and company. Therefore, so the comforting conclusion goes, the much smaller Clinton deficits will have a much greater impact per dollar of spending

than the Bush deficits.

Though this may be the popular view, it's pure baloney. An inviolate economic fact is this: A government that pays out more money than it takes in, raises total incomes — consumer incomes and business profits taken together — in the private sector by this same amount. For example, since December 1990, real disposable personal incomes without transfer payments (the influence of the government, in other words) actually fell in the United States from $3,473 billion to $3,380 billion. Therefore, had it not been for soaring public transfer payments (as shown in Sindlinger's chart), financed by soaring government borrowing, consumer spending would have slumped sharply over this period.

Clearly, so far, the sharp rise in the deficit has prevented a much deeper recession. But though the dosage was massive, it failed to trigger a self-reinforcing recovery. That's the central point to see. And furthermore, Clinton now inherits a deficit of $300 billion, whereas Bush only inherited a deficit of $150 billion from Ronald Reagan.

THE DRAGS TO RECOVERY

To know where the economy is going, one first has to establish where one is starting from. In this vein, it is extremely important to realize how much of the recent growth, as weak as it was, was based on export stimulus and consumption force-fed through massive fiscal stimulus.

Looking out to 1993, the first thing to note is that the foreign export engine has shifted into reverse. A steadily rising trade gap — from $59 billion at an annual rate in the first quarter to $103 billion during the recent quarter — has begun to act as a drag on the economy and business profits. This slump alone, we should point out, already eclipses the incremental spending plans of the Clinton administration.

An additional drag on the economy is also likely as a result of the aftermath of the fiscal policies instituted in February of this year which cut employer withholding rates of income taxes. This measure had been designed to invigorate the economy by giving consumers more purchasing power earlier in the year. The result of this shift will be a fiscal contraction next year due to a reduction in tax refunds and larger pent-up tax liabilities.

But, even though the fiscal stimulus to consumption will shrink next year, the fiscal mess will worsen substantially due largely, but not solely, to the temporarily suppressed borrowing requirements of the bank and thrift bailouts. These borrowings, which substitute government debt for bank and S&L debt, actually exert a contractive effect on the money supply as we have already explained in previous letters and in a Wall Street Journal article.

THE BUILDING CYCLE IS THE CREDIT CYCLE

If, for the reasons reviewed, exports and consumer spending cannot provide the locomotive force for a U.S. recovery, what is left? It can only be investment spending. Actually, two specific categories of investment have regularly led former cyclical upturns — residential building and inventories.

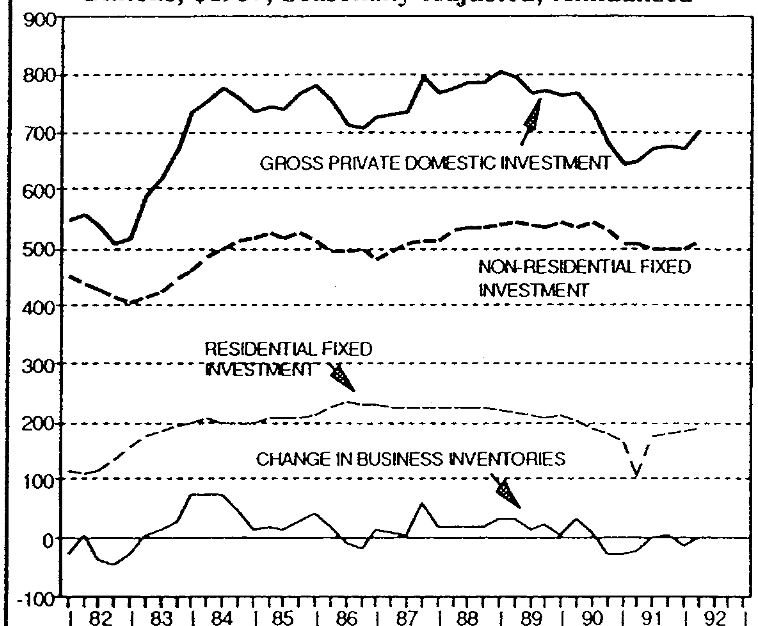
A look at the chart on the next page showing gross private investment reveals a telling story. Comparing the periods of 1983-84, the first two years of the Reagan-Volcker recovery, and 1990-92 in the chart points out an unusual anomaly. Both were periods of drastic monetary easing but the stimulative effects

on investment expenditures were diametrically opposite. In 1983-84, investment spending spurted — most of it inventories and residential buildings — accounting for 66% of total GNP and demand growth in that period. As production soared, real disposable income growth rose 3.5% in 1983 and then soared to 6.7% in 1984, fuelling an immediate consumption boom. Real GDP grew 3.9% in the first year and 6.2% in the second. Contrastingly, in 1990, investment spending slumped despite unprecedented interest rate cuts by the Fed.

Noteworthy is what happened to investment spending after its sharp spurt in 1983-84. Even with the extreme excesses in commercial space, it just scraped along before again sliding in 1990. Commercial building today is no higher than in 1983. Aggregate investment spending today is no higher than in 1984. As a share of GDP, it fell from 18% in 1984 to only 13% recently. In contrast, the GNP-share of consumption over this period surged from 64% to almost 68%.

U.S. GROSS PRIVATE DOMESTIC INVESTMENT

Billions, $1987, Seasonally Adjusted, Annualized



Source: U.S. Department of Commerce

Lately, investment spending seems to have stabilized. Equipment outlays are strong, and residential building has shown the green shoots of recovery. However, this strength is really only in the eye of the beholder. The equipment component is extremely lopsided and narrowly limited to three items — office equipment, aircraft, and autos. In the case of autos, the strength originates in trucks, buses, leasing and fleet sales. On the other hand, industrial equipment outlays are down 25% since 1989.

HISTORICAL PARAMETERS AND PRECEDENTS FOR RECOVERY

In our quest for a locomotive candidate, we sifted the annals of business cycle history for any illumination, particularly in the case of prolonged recessions, if not depressions. In the U.S., there have been three comparable periods of that kind, constituting a class by themselves. They followed the economic peaks of 1872-73, 1892, and 1929.

The history books all stressed that these three depressions had one common feature that distinguished them from the more frequent and shorter cyclical recessions. All three depressions coincided with a sharp, protracted decline in building construction (plant investment, commercial and residential building). With respect to the Great Depression of the 1930s, it's noteworthy to observe that the construction boom of the 1920s was the greatest in U.S. history. Construction has always been an enormously important industry in American life.

In his book, Business Cycles and National Income (1951), Professor Alvin Hansen states: "*When the downturn of a major business cycle coincides with a slump in building, the ensuing depression is likely*

to be severe and prolonged. If, however, the major-cycle downturn comes when the building cycle is on the upgrade, the depression is likely to be shorter and less severe."

It's not difficult to see why this is so. Firstly, building construction normally reacts very responsively to a monetary easing; secondly, construction has very big multiplier effects which impacts many other industries; thirdly, being capital and credit-intensive, a building boom by necessity involves massive money and credit creation. Throughout the 1982-92 period, for example, mortgages accounted for more than 60% of total private credit growth.

After rising for virtually 40 years, the American building cycle peaked in 1985-86, well before the general business cycle. Despite the Fed's record interest rate cuts since 1989, total building volume is still down 20%. The building cycle is the credit cycle. We guess construction is the core of the Kondratieff cycle.

Remarkably, there is weakness in all categories of building, including producers' plant, commercial and residential building, although for different reasons. For industrial plant, wide-spread downsizing of corporate America points to profit and structural problems unseen since the Great Depression. Commercial and office real estate remains depressed due to a vast overhang of supply resulting from the past excesses. Residential housing, last but not least, suffers from sharply slower household formation due to lower adult population growth.

Housing, at least, has recovered from its lows of 1990-91. While that may be true, its recovery is a mere shadow of what's normal, and for that matter, is already petering out. In the third quarter of 1992, residential building was up 11% against a year before, comparing dismally with normal gains of 40-60% in past recoveries. Most people, it appears, have no idea what a genuine housing recovery looks like.

THE BREAKPOINT: ABORTED BUSINESS CYCLE DYNAMICS

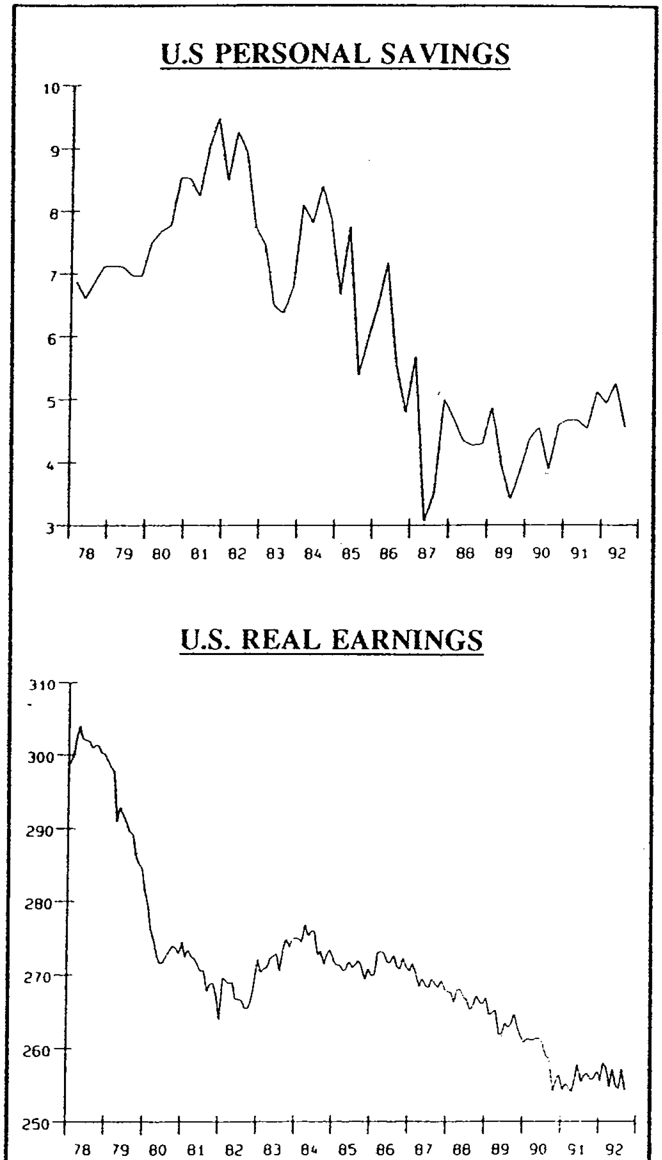
Is there anything that could possibly reinvigorate the U.S. economy? Yes, rising consumer confidence we are told. Indeed, many hold the view that the main ingredient missing for an economic recovery is consumer confidence. To many people, a recession is simply a matter of attitude. That such nonsense is widely held as truth reveals again how little the essence of America's troubles are really understood.

Plainly, the key constraint on consumer spending is lack of income growth, reflecting low wage gains, sluggish employment growth and falling interest income. If slow growth were truly a function of a lack of confidence, then it would express itself in a higher saving ratio. To the contrary, as we have already pointed out, the savings ratio has declined to 4.5% in the recent quarter and on a secular basis has yet to turn up decisively. As such, as the two graphs show on the next page, it's clear: What's causing anaemic consumer spending is unusually anaemic income growth.

The financial markets, though, seem to want to focus on only one thing: the forthcoming new fiscal stimulus from Clinton and his new band of economic tinkerers. There is surely every reason to welcome higher infra-structure spending and an investment tax credit, but new deficit spending becomes increasingly hazardous the higher the starting point for any incremental deficit stimulus. To quote the just published OECD report: *"There is no scope for any fiscal stimulus without compromising all pretence of controlling the federal budget deficit."*

The most condemning fact is this: There is absolutely no sign of a natural business cycle dynamic taking

hold. Soaring inventories and a robust building upswing associated with broad money and credit growth are the necessary hallmarks of such a recovery mechanism. Instead, what we see is an aborted business cycle dynamic. All of the tell-tale elements are progressing at a sluggish pace well below normal. The last time the business cycle recovery mechanism clicked into overdrive in 1983, M2, M3 and debt grew 10 to 12%. Currently, they're barely crawling at a 2% rate. That's no recipe for a sustainable recovery.



Source: International Strategy and Investment

LOOKING ABROAD

While many economists and analysts are working overtime to be among the first to pick up the faint scents of recovery in the U.S. economy, they are working just as hard to glean material necessary to support their doom and gloom stories for Europe. By normal cyclical standards, generally projected U.S. GDP growth of only 2 - 2.5% next year would be a poor performance. However, it is magically embellished with the argument that it compares very favourably with prospective growth in Continental Europe for which just about everyone seems to foresee a long bout of economic stagnation.

As we have frequently pointed out, economic comparisons between Germany and the U.S. are a bit lopsided. For one, knowingly or unknowingly, it is conveniently ignored that the economic trend changes of these two countries have completely different starting points. It needs to be remembered that Germany has had 10% real GDP growth since 1989 as compared to near zero for the United States.

To understand what's happening in Germany, one has to recognize two things: The first is that the German economy always tends to respond very slowly to the world economic cycle. Like Japan, it's an export-led economy. But unlike Japan, it is led by capital rather than consumer goods. Capital exports have a long lead-time. The second point is that unification with the former East Germany came at a time when the German economy was already at its cyclical peak. Instead of helping to flatten out the peaks and troughs of the cycle, it prolonged the boom and made the peak higher. Unavoidably, this will serve to make the following trough deeper.

Recessions are always periods in which the things that went out of control during the previous boom are

adjusted back to reality. Therefore, the severity of a recession depends largely on the magnitude of the prior boom's excesses and maladjustments and the speed at which the re-adjustments take place.

Comparing the situation in Germany with that in the United States, Britain and some other countries, we see one very important difference: Germany's and the rest of the downturns evident in the major Continental European economies are of the normal cyclical type, being mainly characterized by an inflationary overheating near their peak. Both household and corporate balance sheets are healthy; corporations financed an investment boom largely from self-generated cash flows; consumers stuck to the old-fashioned principle of saving before spending; and consumer debt as a percentage of disposable income is less than 15% in Germany whereas in Britain, Canada and the U.S., consumer debts are at least 70% of disposable income and more. Correspondingly, the banking system is in good shape. And, given the large influx of people from Eastern Europe, there is a severe housing shortage.

The upshot of all this for Germany and the major Continental European countries is that they have none of the Anglo, Scandinavian or Japanese type structural and financial calamities — no debt crisis, no banking crisis, no deep real estate or profit crisis . . . just a normal recession. Germany's main problems are a weak world economy that is undermining its exports, recent excessive wage rises which impinge upon corporate profits and competitiveness, and the adverse effects of the rebuilding of East Germany.

In our view, the greatest risk for Germany is on the export front because we do not share the general optimism about a U.S.-led world economic recovery. The world faces a deeper and longer slump than is generally realized. This isn't Germany's only concern. But at the German wage front, considerable moderation already looks certain.

THE BUNDESBANK HAS LITTLE CHOICE

Despite such extended economic weakness, the Bundesbank is in no hurry to lower interest rates. Inflation, wages, money supply growth and budget deficits remain at the forefront of its concerns and will continue to as long as these issues are perceived as a threat to medium-term price stability. Be that as it may, we think that it is utterly naive to attribute Europe's economic weakness mainly to high German interest rates, especially so considering the ineffectiveness of ultra-low interest rates elsewhere. It should be remembered, too, that high interest rates have a much lower direct impact on consumers and corporations in the major Continental European countries. For consumers, credit plays less of a role and since saving is high, there are more beneficiaries of higher interest rates than there are debtors.

That still leaves the other major topic that tends to create such gloom about Germany — its budget deficits. As already pointed out in the last letter, the general anxiety attributable to these deficits (which mainly result from unification) is one thing, the objective facts are another — especially so in the light of international comparisons. Many countries — the United States, Britain, Canada, Italy . . . etc. — have even bigger deficits without the stresses of unification. The difference in these countries is that nobody cares . . . in fact, to the opposite, pundits are prescribing higher deficits to ensure economic recovery.

Germany's high budget deficits appear more bothersome than others because the Bundesbank has declared war on them with high interest rates. It is aware of the difficulties that its policy is creating for other nations, but it is not ready to abandon stability. This resolve, importantly, is supported by public opinion which is alarmed about the unusual rise of government debt presently. Other countries seem to be much more permissive in this regard, allowing a government debt build-up with equanimity and complacency.

We often hear praises of American optimism and laments about the dour German pessimism. It always reminds us of this quote from Schumpeter: *"For this is one of those situations in which optimism is nothing but a form of defection."* What counts in the end, of course, is the action that follows. Optimism that prevents any corrective action — as in America — is destructive. Pessimism that induces corrective action — as in Germany, for example — is constructive.

GLOBAL CURRENCY TRAVAILS

For Europe as a whole, the limelight is on the slowly worsening economic news and the repeated turmoils in the currency markets. The coincidence is certainly not accidental. Currency crises tend to be triggered by bad economic news which signal to the currency markets the need for interest-rate cuts. Sweden's Riksbank threw in the towel on the day when very weak retail sales were reported. After having defended its Krona with bank rates as high as 500%, Sweden finally gave up and allowed its currency to float. The Krona promptly fell 9%. The same trouble can apply to both floating and fixed exchange currencies.

A case in point is the Canadian dollar which is a floating currency. There, too, it was primarily a barrage of unexpected gloomy reports on Canada's economic prospects and its debt ratings that sent the Canadian dollar reeling. As we had warned on several occasions, the Canadian dollar was highly vulnerable to a fall. It has since declined 12% against the U.S. dollar in less than a year.

All the economies with wobbly currencies have two other distinctive features that worry the markets: large and rising current account and budget deficits which require permanently high capital inflows that become ever more doubtful in an environment of falling interest rates. So far, the great exception is the United States where the prospect of a rising budget deficit is strangely seen as a boost to the dollar.

For us, the currency realignments in Europe were long overdue because the great "convergence" theme on which the European Exchange Rate Mechanism (ERM) system had flourished in the past years, was based on a huge fallacy. For years, the weakest currencies — those with the highest inflation rates and the biggest budget and current account deficits which have now been devalued — were bolstered by international capital inflows which were attracted by their high interest rates. These flows had truly insane dimensions. Take the Spanish peseta as an example: In the course of its compulsory interventions to prevent the peseta from rising above the ERM grid, the Spanish central bank accumulated foreign exchange reserves of $71 billion, the largest currency-reserve arsenal in the OECD.

What's next for Europe? That's a key question. Essentially, Europe has to return to the ERM system as it was originally conceived . . . that is as a system with more frequent but smaller exchange rate adjustments. In the last analysis, the most important question is whether or not the weak-currency countries — Britain, Spain, Italy, etc. — will be able to strengthen their currencies by adopting appropriate internal policies in keeping with the D-mark. Our answer? It's hardly likely. Looking at the fundamentals and the policies of these countries, we see a progressive deterioration and further currency weakness. With little regret, we also conclude that European Monetary Unification (EMU) — a common European currency — will essentially fall by the wayside.

THE WORLD'S NEW SUPER BUBBLE

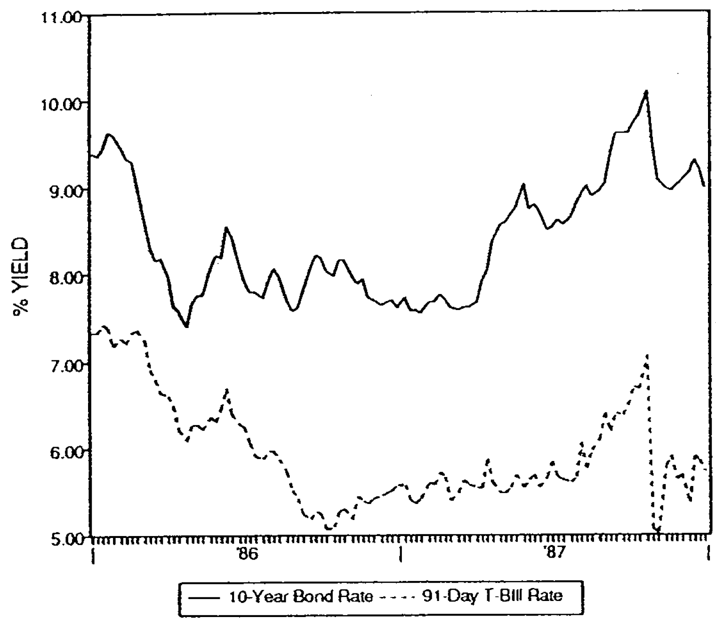
Before closing, we need to revisit another pressing subject — the world's latest stupendous debt bubble. The object of this latest craze are medium- and long-term U.S. government bonds; its playing field is the

attractively inclined U.S. yield curve.

The key ante to be able to enter this speculative game is access to cheap credit in the form of Fed funds, Euro dollars and broker reverse repos which currently cost between 3-4%. This money is then used to buy mainly medium-term Treasury notes which yield interest at between 5-6%.

This interest-rate game — buying long and borrowing short — really got going early last year. Now, it has carried on to the point where commercial banks have more Treasury and government agency securities than they have business loans outstanding. Since the end of March 1991, bank holdings of government bonds have expanded by more than $200 billion as compared to total loan growth of only $50 billion. As might be expected, the most aggressive players, both as big buyers for their own account and lenders to their speculating customers, are brokers and dealers. As a group, they now carry bond inventories well over $250 billion. That's far higher than the last peak seen in 1986, when these portfolios temporarily surged to $60-70 billion.

U.S. INTEREST RATE TREND
1986-1987, Weekly



Except for a few bouts of market indigestion, it's been smooth sailing so far. What's odd, though, is that such a tremendously large credit-financed bubble has not been more successful in bringing down U.S. long-term interest rates. Clearly, and literally, too, the bond market has been living on borrowed time.

It is still part of market folklore, that U.S. long-term interest rates will yet slide dramatically once the wrongheaded inflation expectations subside. Conveniently, the most obvious cause of these high rates is completely ignored — a virtual explosion in government borrowing. Including government agencies, total borrowing has soared by $1.1 trillion or 30% since the end of 1989. Current new borrowing in the second quarter of 1992 amounted to $551 billion as compared to a total of $300 billion for all of 1989.

Considering this gigantic speculative bond bubble, we wonder what would happen if the Fed would ever start to tighten its monetary reins as the dollar bulls presently assume. Obviously, it would trigger a dead stop in this speculation, causing the dumping of hundreds of billions of dollars worth of bonds into a totally unreceptive market. The last time such a bubble burst was in 1987 following the easy money period of 1985-86. But compared with today, that bubble then was small by comparison. Yet, when it burst in 1987 (see graph) it sent U.S. medium- and long-term rates soaring, contributing to the infamous October stock market crash.

CONCLUSIONS

The most pivotal question for 1993 is whether or not the U.S. economy will be able to break out of its anaemic growth pattern, thereby pulling the world's economic wagon train out of the doldrums. We see no convincing evidence. The U.S. economy remains pinned down by serious structural difficulties.

We aren't fooled by America's apparently good third quarter GNP statistics. The figures are a travesty. In absence of a new strong demand stimulus, an economic relapse appears virtually certain. And when that happens, the rosy bloom on the U.S. dollar will fade into another bout of weakness.

At some point, protracted anaemic growth, if not an economic relapse, will crack the veneer of complacency in the financial markets and lead to a confidence crisis which will take everything down — the dollar, U.S. bonds and stocks — just as is already unfolding in some of the deficit countries with weak economies and cumulating budget and trade deficits such as Canada, Australia, and Sweden.

Importantly, the urgent warnings of history shouldn't go unheeded. Experience suggests that a long, painful, sometime unpredictable, adjustment period is in store for the world economy and its financial and currency markets. Plainly, sobriety and lower expectations are in order. Investors are dealing with an economic and financial environment that's completely foreign to today's generation of "secular bull market babies."

We already see the hallmarks of such a period. After many years of helter-skelter expansion in international credit, it is now ominously contracting. And not to forget: this downturn is one of those rare, deep-seated varieties that is associated with a secular contraction in building and construction.

Long-sighted investors should continue to stick to hard-currency, high quality, European bonds. But we must caution on the selection of currency. Currency volatility is extremely high. Another aborted U.S. recovery will be stressful on the dollar as well as the ERM and perhaps even the French franc. We think it's best to focus on the sovereign bonds of Germany, Switzerland, the Netherlands, Austria and Belgium.

Dear Readers: Our special service report How To Buy Hard-Currency Bonds is still available. For a free copy, please contact our administration office.

Next Mailing: January 13th, 1993

*** SEASONS GREETINGS ***

Publisher and Editor, *Currencies and Credit Markets*: Dr. Kurt Richebächer
Mendelssohn Strasse 51, D-6000 Frankfurt 1, GERMANY. TELEPHONE: 49-69-746908 FAX: 49-69-752583

Subscription and Administration Inquiries: Mulberry Press Inc. 7889 Sixteen Rd., Caistor Centre, **Ontario, CANADA, L0R 1E0. TELEPHONE: 416-957-0602 FAX: 416-957-0602.**

Annual Subscription Rates: 12 Issues. Europe: DM 600.00. Subscribers outside of Europe: $US 400.00